

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Speier Analyst: LuAnna Hass Bill Number: SB 285
Related Bills: See Legislative History Telephone: 845-7478 Introduced Date: February 19, 2003
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Innocent Spouse Relief

SUMMARY

This bill would provide that, in certain cases, if an individual receives income tax relief under the federal innocent spouse provisions, that individual would also receive income tax and penalty relief under the state innocent spouse provisions.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to allow taxpayers who request innocent spouse relief at the state level to receive the same determination that was received at the federal level.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative January 1, 2004.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

The federal Internal Revenue Restructuring and Reform Act of 1998 made innocent spouse relief easier to obtain. The Act allows an innocent spouse to qualify for relief under one of the following provisions:

1. *Understatement/Apportionment.* To qualify for relief the taxpayer must show that the understatement of tax is a result of an erroneous item. In addition, the taxpayer must show that at the time the return was signed he or she did not know and had no reason to know of the understatement of tax. Another option allows the requesting spouse to show partial liability. To qualify for relief from the liability that is attributed to the portion of the understatement of income, the taxpayer must show the same lack of knowledge, as described above, when they signed the return.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director
Gerald H. Goldberg

Date
03/24/03

2. *Separate liability election.* A requesting spouse may elect to be taxed as though he or she filed a *married filing separate* tax return. Any liability for understatement of tax, interest, and penalties will be limited to the amount attributable to the income the individual spouse actually earned. This relief is available to taxpayers who are no longer married, are legally separated, or have lived apart from their spouse for 12 months prior to requesting relief. At the time the joint return was signed, the requesting spouse must have lacked actual knowledge of the item resulting in the tax deficiency.
3. *Equitable relief.* The Internal Revenue Service (IRS) determines from a review of all the facts and circumstances that the requesting taxpayer would not qualify for relief under either 1 or 2 above and it would not be equitable to hold the requesting spouse liable for any unpaid tax or any deficiency.

In 1999 California conformed to portions of the 1998 federal Act by enacting the Taxpayer Bill of Rights Act of 1999, which revised and expanded innocent spouse relief at the state level. As a result, this California innocent spouse provision was based upon, and similar to, the federal provision. Under California law disputes involving innocent spouse issues are heard by the State Board of Equalization (BOE).

Under state law, the Franchise Tax Board (FTB) is required to provide notice and appeal rights to the taxpayer on the joint return that did not request the innocent spouse relief. These rights ensure that both parties to a joint return receive due process. Essentially, the non-requesting taxpayer is given notice that the spouse is requesting relief under the innocent spouse provisions. At that time, the non-requesting taxpayer may provide FTB information to show why the spouse may not qualify for innocent spouse relief. In the event FTB grants relief to the requesting spouse, FTB is then required by law to inform the non-requesting taxpayer that relief has been granted to the spouse. The non-requesting taxpayer also is informed of their right to file an appeal with BOE.

California law allows two avenues for relief that are not available under federal law.

1. *Relief from Self-Assessed or Deficiency Tax Amounts by Court Order.* A taxpayer may seek a divorce court order relieving the taxpayer of joint and several liability for state income tax on a joint return as well as state income tax resulting from an audit. The order cannot relieve tax on any income that was earned by or derived from assets under the exclusive control and management of the taxpayer seeking relief. The gross income reported on the return must not exceed \$150,000 and the tax liability must not exceed \$7,500. The court order must state the tax years involved and can revise only unpaid tax amounts. In those instances where either the gross income or the tax liability exceeds the thresholds for relief, and the taxpayer wants judicial relief, the taxpayer must obtain and file with the court an FTB Tax Revision Clearance Certificate.
2. *Relief from Self-Assessed Tax Amounts.* A taxpayer may seek relief from the department on any unpaid self-assessed tax liability on a joint return, including penalties and interest. The tax liability must not be attributable to income that was under the exclusive control and management of the taxpayer seeking relief. State law requires the taxpayer to demonstrate that he or she did not know and had no reason to know of the nonpayment of tax at the time the return was filed.

THIS BILL

This bill would provide a rebuttable presumption (see description below) that if an individual receives income tax relief under the federal innocent spouse provisions, that individual would also receive income tax and penalty relief under the state innocent spouse provision.

Under this bill, once an individual requests innocent spouse relief from FTB (see "Program Background") it would be presumed that the facts and circumstances that lead to the favorable federal innocent spouse relief determination would be sufficient to grant innocent spouse relief at the state level, unless the presumption is rebutted with evidence contrary to the facts and circumstances that lead to the federal conclusion. If the presumption is rebutted, FTB staff within the Innocent Spouse Program would make a separate innocent spouse determination on the merits of the evidence presented. If the presumption is not rebutted, the taxpayer is granted innocent spouse relief for state income tax purposes.

IMPLEMENTATION CONSIDERATIONS

Since this bill provides a rebuttable presumption as explained above, the department anticipates that a separate determination could still be made at the state level if the presumption is rebutted. However, the department suggests clarifying the procedures that would provide for similar state relief or separate state determinations by addressing the following concerns:

- This bill would be effective and operative January 1, 2004, but does not specify whether the provisions of the bill would apply to requests for relief received prior to January 1, 2004. For clarification and ease of administration, department staff suggests amending the bill to be operative for innocent spouse requests received on or after the effective date of this bill.
- This bill states that an individual would receive relief from "taxes and penalties" under the state innocent spouse provision if the individual received relief at the federal level. However, an individual may receive relief from tax and penalties at the federal level for an issue or liability unrelated to an issue or liability under state income tax law. For example, the requesting spouse may have received relief at the federal level on income that is not subject to tax in California, such as social security benefits. Under this bill, the requesting spouse would then be entitled to relief from "tax and penalties" under the state innocent spouse provision even though they would not have a tax liability for social security benefits. As a result, this bill could be interpreted to allow the requesting spouse relief at the state level for "tax and penalties" regardless of the nature of the tax liability. Department staff recommends amending the bill to clarify that a requesting spouse that received relief at the federal level would be presumptively allowed relief at the state level to the extent that the issues and liabilities in question are the same. To the extent that the issues and liabilities in question differ, the state should then be allowed to make the appropriate adjustments to those additional items where California does not conform to the federal tax law provisions upon which the federal relief was granted.
- Under current state law, the burden of proof is on the requesting spouse to show entitlement to innocent spouse relief. This bill would shift the burden of proof to FTB if the individual has received a favorable determination at the federal level. However, this bill does not require the individual to provide FTB with a copy of the IRS determination that states whether relief was granted and if so, the type of relief. As a result, the following issues may arise:

- FTB may not be able to obtain the evidence needed to rebut a presumption of the federal correctness of the determination. Although the department may access certain IRS information, the information that the department receives does not specify the type of innocent spouse relief received.
- FTB would be unable to provide meaningful notice and appeal rights to the non-requesting taxpayer, as discussed under “Federal/State Law.” As a result, the non-requesting taxpayer would not have an opportunity to submit rebutting evidence to FTB or BOE regarding the spouse.

Department staff suggests amending the bill to require the requesting spouse to provide FTB with the IRS determination letter, which outlines the type of relief granted, and all evidence submitted to the IRS that resulted in the determination to grant relief.

- Since federal law does not contain a statute similar to California’s relief from joint and several liability through a divorce court order, the IRS may grant relief under the innocent spouse provision of equitable treatment, as discussed under “Federal/State Law.” This bill could be interpreted to allow the requesting spouse relief under the state innocent spouse provision of equitable relief instead of the state statute regarding relief from joint and several liability through a divorce court order, which has different requirements for granting relief.
- Current state law requires an individual seeking relief under the innocent spouse doctrine of a separate liability election, as discussed under “Federal/State Law,” to request such relief within two years of the date FTB begins collection action with respect to the requesting spouse. Under this bill it is unclear if an individual who receives relief at the federal level through the separate liability election must still meet the two-year deadline for relief at the state level.
- A spouse requesting relief under the state innocent spouse provisions must pay the tax on the income that they earned, managed, or controlled in order to qualify for relief. Often relief is denied in instances of prior tax years where FTB records have been purged and the requesting individual is unable to verify their withholding for the year in question. Under this bill, if the IRS granted relief then FTB could be required to grant similar relief even though the department may be unsure or unable to verify that the requesting spouse has paid the appropriate share of tax.

PROGRAM BACKGROUND

Under federal and state income tax law, spouses who file a joint tax return are each responsible for the accuracy of the return and for the full tax liability for that tax year. These obligations apply regardless of which spouse earns the income. The concept of obligating each spouse separately for all of the tax liability is called joint and several liability. Joint and several liability can result in inequitable consequences to one spouse in certain circumstances. Consequently, the federal government and California enacted “innocent spouse” legislation, which may allow a spouse to be relieved of some or all of the responsibility of a joint tax debt.

It is FTB's current practice that a taxpayer requesting innocent spouse relief in California has the right to a determination based on the facts presented to the department, regardless of any relief or denial of relief by the IRS. An individual seeking relief under the California innocent spouse provisions is required to complete a Request for Innocent Spouse Relief election form (federal Form 8857) and submit it to FTB's Innocent Spouse Program. During its determination process FTB staff takes into serious consideration whether the IRS granted or denied relief to the requesting spouse. While there is no presumption that FTB should grant the same relief to the requesting taxpayer as the IRS, FTB is also not limited to providing the same relief as the IRS. For example, by making a separate determination, FTB may grant a requesting spouse complete relief where the IRS may have granted partial relief or no relief.

LEGISLATIVE HISTORY

AB 2979 (Assembly Revenue and Taxation Committee, Stats. 2002, Ch. 374) increased the gross income and tax liability thresholds to qualify for relief under a divorce court order to reflect inflation from 1977 to 2001, so that the amounts became \$150,000 for the gross income threshold and \$7,500 for the state income tax liability threshold.

OTHER STATES' INFORMATION

A review of *Alabama, Arizona, Colorado, Iowa, Illinois, Kansas, Louisiana, Maine, Missouri, Nebraska, Oklahoma, Pennsylvania, and New York* tax laws found that none of these states have enacted legislation providing for a similar rebuttable presumption (as described under "This Bill") to grant state innocent spouse relief based on a federal determination.

- *Iowa and Louisiana* law contains language similar to California.
- *Maine* provides that the factors for federal relief will be used for determining state relief.
- *New York* provides for relief similar to federal and California innocent spouse statutes prior to their revision in the late 1990's (see "Federal/State Law").
- *Illinois and Pennsylvania* provide that relief would be granted under the same circumstances that resulted in federal relief, except that these states do not have an equitable relief provision.

The remaining states provide that a state determination for innocent spouse relief would be in the same manner, or comparable to the federal determination.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until the implementation concerns have been resolved. The inability under this bill to require the federal letter of determination to be included with a request for innocent spouse relief could cause FTB to expend considerable resources conducting independent investigations and gathering information.

ECONOMIC IMPACT

This bill would have a minor revenue impact. It is anticipated the revenue loss would be less than \$100,000 annually.

According to department statistics there have been fewer than 300 requests for innocent spouse relief since September 2001. Half of those requests were granted. Of the requests that were granted, a revenue loss would only occur in cases where the IRS granted relief to a spouse (Spouse A) other than the spouse granted relief at the state level (Spouse B). Under this bill the state would then be required to grant relief to that other spouse (Spouse A). As a result, taxes and penalties could not be collected from either spouse on the joint return in question.

Additionally, this bill could have an impact on the collection of taxes and penalties owed on joint returns. For example, if the IRS grants tax relief to a spouse who would not have been granted tax relief under state law, and that spouse was the only spouse who had assets from which the taxes and penalties could have been collected, the state would be unable to collect the taxes owed on that joint return.

ARGUMENTS/POLICY CONCERNS

This bill would add a subdivision rebuttably presuming that, “notwithstanding any other law,” if an individual receives income tax relief under the federal innocent spouse provisions, that individual would also receive similar relief at the state level. The inclusion of this phrase could create conflict with another state income tax law discussed above under “State/Federal Law” that provides relief from joint and several liabilities through a divorce court order. That law states that a spouse that controls the disposition of or who receives or spends community income is liable for the tax on that income. The phrase “notwithstanding any other law” as used in this bill could be interpreted to override that law.

As discussed under “State/Federal Law,” California law allows avenues for relief that are not available under federal law, including relief from joint and several liability through a divorce court order. It is possible that Spouse A could receive relief through a divorce court order and subsequently Spouse B requests and is granted innocent spouse relief at the federal level. Under this bill, if FTB were unable to rebut the federal presumption, Spouse B would be entitled to state innocent spouse relief. As a result, neither spouse would be liable for the state income tax liability. The ability of Spouse B to gain relief under this bill would be contrary to the California divorce court order that specified Spouse A was entitled to relief from the joint and several liability.

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